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CITATIONS

826146—49

In the Supreme Court of the United States

October Term, 1948

No. 538

Lee M. Friedman, petitioner

v.

Denis W. Delaney, Collector of Internal Revenue for the District of Massachusetts

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 8–15) is reported at 75 F. Supp. 568. The opinion of the Court of Appeals (R. 80–84) and the concurring opinion (R. 84–89) are reported at 171 F. 2d 269.

JURISDICTION

The judgment of the Court of Appeals was entered on December 13, 1948. (R. 89.) The petition for a writ of certiorari was filed on January 31, 1949. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Where taxpayer, in attempting to effect a composition of claims against his bankrupt client, assuring attorneys for the creditor and the referee in bankruptcy that the necessary $5,000 would be forthcoming and subsequently, without legal obligation, provided $5,000 from his own funds upon his client's failure to do so, was that expenditure deductible either as an ordinary and necessary business expense under Section 23 (a) (1) or as a business loss under Section 23 (e) (1) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

> SEC. 23 [as amended by the Revenue Act of 1942, c. 619, 56 Stat. 798, Sec. 121]. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—(1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition

to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (s), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. As to charitable contributions by corporations not deductible under section 23 (a), see section 19.23 (a)–13. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See section 19.22

(a)–5.) Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see section 19.23 (a)–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. * * *

SEC. 19.23 (e)–1. *Losses by individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of

the following sections of the Internal Revenue Code: Sections 23 (g) and 117, relating to capital losses; section 23 (h), relating to wagering losses; section 24 (b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possessions of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

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STATEMENT

The facts, as summarized from the stipulation and the District Court's opinion, are as follows:

Taxpayer, an attorney who has been at the bar for over fifty years, is the senior member of the Boston law firm of Friedman, Atherton, King and Turner. (R. 8, 72.) This firm was for many years counsel for one Louis H. Wax, a businessman, who was in financial difficulties in 1937. (R. 8.) On Mr. Friedman's advice, Wax proposed that his creditors accept ten cents on the dollar in settlement of their claims against him. This settlement required about $8,000, part of which was promised by and later actually paid by Wax's new employers, Messrs. Goffman and Kaufman

(doing business as "Gofkauf"), and $5,000 of which Wax proposed to realize from an insurance policy on his life, payable to his wife and not available to his creditors without her consent. (R. 8–9.) Taxpayer then told several different lawyers representing Wax's creditors about the arrangement with Gofkauf and Mrs. Wax, and states that he said to them (R. 9):

> I had that policy and I knew that I would get that money and I would see that he got the dividend if he induced his creditors to accept.

Taxpayer did not say that he would pay Mr. Wax's creditors from his personal funds, but that "he was morally certain that Mr. Wax would carry out what he said he would do." (R. 9.) Taxpayer also told the referee in bankruptcy proceedings later instituted that he was in a position to give the court the assurance that if the ten per cent composition with Wax's creditors was accepted and confirmed, then the money was available to carry it through. (R. 9.)

Ultimately, Mr. and Mrs. Wax refused to make the insurance policy available to the creditors. In February, 1938, "wholly because he had involved himself in commitments to other attorneys and to the referee", taxpayer deposited $5,000 of his own money and $2,000 from other sources, a total of $7,000, with the Clerk of Court, with a statement that no part of the deposit had been paid by Wax, and that it was not a part of Wax's

estate. (R. 9.) This caveat was not based on the ground that the deposit was special, or in escrow, but merely indicated that the money was from persons other than the bankrupt—the type of statement which might appropriately accompany a deposit of money from proceeds of an insurance policy, or from Mrs. Wax, or from any source other than the bankrupt. (R. 9–10.)

In the summer of 1938 taxpayer told Wax about the deposit, and the latter refused to reimburse him. In 1939, taxpayer filed a petition with the referee in bankruptcy to recover the $5,000, which the referee denied in 1941. (R. 10.) In his 1941 income tax return, taxpayer deducted $5,000 as a "bad debt", which it concededly is not. (Pet. 5.) The Commissioner disallowed the deduction, a deficiency of $3,411.47 was assessed and paid, and this suit for refund was timely brought by taxpayer against the Collector. (R. 10, 64, 73.)

The District Court held that the expenditure was not an ordinary and necessary expense within the meaning of Section 23 (a) (1) and was not a business loss under Section 23 (e) (1) of the Internal Revenue Code. (R. 12–15.) The District Court held further that even if any deduction were proper it would have been proper only in 1938 and not in 1941. (R. 10.) The majority opinion affirmed along the lines taken by the District Court. (R. 80–84.) The concurring opinion held that taxpayer could not prevail on the

facts since the record showed that the expenditure was not made in fulfilment of taxpayer's moral obligation as contended, but rather in connection with a compromise entered into in 1941, and not shown to have been connected with taxpayer's business. (R. 85–89.)

ARGUMENT

1. The holding of the lower court that the voluntary assumption by an attorney of an obligation which was in origin that of his client, and the subsequent payment made in accordance therewith resulted neither in a deductible business expense under Section 23 (a) (1), *supra,* nor in a deductible business loss under Section 23 (e) (1), *supra,* is clearly correct. The expenditure arose from the taxpayer's gratuitous and voluntary assurances. Though taxpayer stressed the necessity for him as an attorney to keep his word once given, the lower court properly examined the origin of the obligation, concluding that it was not part of taxpayer's business to underwrite or pay the obligation of his client. The court properly determined that such an expenditure was not "ordinary and necessary" within the meaning of Section 23 (a) (1), and further that it did not constitute a business loss under Section 23 (e) (1) of the Internal Revenue Code inasmuch as it was not incurred in taxpayer's business and was entirely voluntary and intentional. The decision of the court has the support of a wealth of au-

thority from other Courts of Appeals[1] and is in harmony with this Court's decisions in *Welch* v. *Helvering,* 290 U. S. 111, and *Deputy* v. *du Pont,* 308 U. S. 488.

2. The purported conflict between this decision and decisions of other Courts of Appeals is non-existent. In *Dunn & McCarthy* v. *Commissioner,* 139 F. 2d 242 (C. A. 2), the court held that where taxpayer's directors were of the unanimous and good-faith opinion that a failure to repay loans obtained by its deceased president from taxpayer's top-ranking salesmen would seriously impair the attitude of the salesmen and customers toward the company, and where the facts indicated that the directors' opinion was well founded, the expenditures were deductible under Section 23 (a) (1). In *Helvering* v. *Community Bond & Mortgage Corp.,* 74 F. 2d 727, the same court held that where a taxpayer made expenditures in order to purchase the stock of an agency so that it might procure the cancelation of the agency's contract to sell the taxpayer's stock and thus avoid business losses consequent upon the agency's practices, such expenditures were deductible under Section 23 (a) (1). These cases are distinguishable from the

[1] *A. Guirlani & Bros.* v. *Commissioner*, 119 F. 2d 852 (C. A. 9); *White* v. *Commissioner*, 61 F. 2d 726 (C. A. 9); *Robinson* v. *Commissioner*, 53 F. 2d 810 (C. A. 8); *Sam P. Wallingford G. Corp.* v. *Commissioner*, 74 F. 2d 453 (C. A. 10); *Commissioner* v. *Heide*, 165 F. 2d 699 (C. A. 2); see also *W. F. Young, Inc.* v. *Commissioner*, 120 F. 2d 159 (C. A. 1); *Dresser* v. *United States*, 55 F. 2d 499 (C. Cls.).

instant case for in each of the cases the Court of Appeals was justified on the facts in concluding that the expenditures in their origin were directly and proximately related to the effectuation and preservation of the taxpayer's business; whereas in the instant case taxpayer himself characterized his assumption of a personal obligation as follows (R. 38–39):

> It was due entirely to my getting myself personally into the situation that I see now, as I look back, professionally I ought never to have done.

That the Court of Appeals for the Second Circuit did not intend to announce principles at variance with the decision in the instant case is manifested by the same court's decision in *Commissioner* v. *Heide,* 165 F. 2d 699. In *McGee* v. *Nee,* 113 F. 2d 543 (C. A. 8), the court decided only that it could not state that the finding of the trial court was clearly erroneous where the trial court had held that expenses incurred by an insurance broker in providing reinsurance for its customers, the original insurance having been placed with a company which had become insolvent, were "ordinary and necessary" expenses. In the instant case, the trial court found as a fact that the expenditure involved was not "ordinary and necessary". Moreover, the general legal principles announced by the same court in *Robinson* v. *Commissioner,* 53 F. 2d 810, with which the court did not disagree in the *McGee* case, are entirely consistent with and in

harmony with the decision in this case. As for *A. Harris & Co.* v. *Lucas*, 48 F. 2d 187 (C. A. 5), apart from the fact that that case is clearly distinguishable from the instant case, the decision was premised on the erroneous assumption that Section 23 (a) (1) should be given such broad latitude as to include expenditures which are *either* ordinary or necessary. This decision has of course been overruled in *Welch* v. *Helvering*, *supra*.

Thus the most that can be said for taxpayer's position is that there have been cases where expenditures have been made without legal obligation and have been held on the facts to have been directly and proximately related to the taxpayers' businesses and to have constituted "ordinary and necessary" expenses. However, as this Court stated in *Deputy* v. *du Pont*, *supra*, p. 496, "Review of the many decided cases is of little aid since each turns on its special facts."

3. It is not true that the court treated Section 23 (e) (1) [2] as if it were merely repetitive of Section 23 (a) (1). The court did not indicate that the sections were coextensive. The court held only that the kind of deduction sought here was allowable neither under Section 23 (a) (1)

[2] Whether or not the precise limits of Section 23 (e) (1) have been previously marked out is of no importance, since the only question presented here is whether the particular deduction claimed falls within the scope of Section 23 (e) (1). That it does not is clear.

nor under Section 23 (e) (1). The court's decision in this respect is supported by every appellate decision where the voluntary assumption and payment of another's obligation was considered under both Section 23 (a) (1) and Section 23 (e) (1). *Robinson* v. *Commissioner, supra; White* v. *Commissioner,* 61 F. 2d 726 (C. A. 9); *A. Guirlani & Bro.* v. *Commissioner,* 119 F. 2d 852 (C. A. 9); *Sam P. Wallingford G. Corp.* v. *Commissioner,* 74 F. 2d 453 (C. A. 10); *W. F. Young, Inc.* v. *Commissioner, supra.*

4. In laying emphasis on the fact that taxpayer's assumption of his client's obligation was entirely voluntary from the outset, the lower court gave expression to principles which are neither unsound nor novel. That the voluntary assumption and payment of another's obligation is not "ordinary and necessary" but is generally extraordinary, is well settled by the previously cited decisions of the Courts of Appeals and this Court. Nor is it now necessary to reexamine the proposition since this Court has carefully considered the problem in *Welch* v. *Helvering,* 290 U. S. 111. In connection with the applicability of Section 23 (e) (1) dealing with business losses, it seems manifest that, as a matter of common understanding, a business loss is an unintentional parting with something of value. It is not intentional or deliberate. *Dresser* v. *United States,* 55 F. 2d 499 (C. Cls.). Nor is it reasonable to assume that Congress intended to subsidize the magnanimity

of a taxpayer in underwriting and assuming an obligation of its client, especially where as here taxpayer has himself characterized his action as something which he ought not to have done professionally, and would not have done had it not been for his long association with the particular client. (R. 34, 38.) Moreover the position assumed by the lower court, far from being novel, as taxpayer suggests, has the support of numerous prior decisions. *Dresser* v. *United States, supra; White* v. *Commissioner, supra; W. F. Young, Inc.* v. *Commissioner, supra; Robinson* v. *Commissioner,* 53 F. 2d 810 (C. A. 8); *Sam P. Wallingford G. Corp.* v. *Commissioner, supra; A. Guirlani & Bro.* v. *Commissioner, supra.*[3]

5. In the light of the District Court's determination (R. 10–11), sustained by the Court of Appeals (R. 83) that the deduction, even if proper, would have been proper only in 1938, taxpayer could not prevail were he correct in all contentions presented to this Court. The District Court found that taxpayer had parted with and lost all control over the $5,000 in 1938, and that therefore,

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[3] The lower court did not hold that no expenditure made without absolute legal obligation is deductible. It held only that under the facts in this case it was not part of taxpayer's business either to underwrite or assume his client's obligation. Taxpayer in laying emphasis here as below on the necessity for living up to his moral obligation in order to preserve his professional reputation, overlooked the fact that it was not part of his business to underwrite and assume the obligation in the first place.

being on a cash basis, he would be entitled to a deduction only in 1938, if at all. (R. 10–11.) The majority agreed with this determination. (R. 83–84.) Taxpayer has not attacked this phase of the decision.

CONCLUSION

The decision of the lower court is correct and is not in conflict with decisions of any other Courts of Appeals. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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